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Emerging Markets Queries in Finance and Business

The need for public sector consolidated financial statementsAndreea Cîrstea^{a,*}^a*Babes-Bolyai University, Teodor Mihali 58-60, 400591 Cluj-Napoca, Romania*

Abstract

The public sector has undergone a series of reforms, reforms that have had a great influence on the development of public accounting and reporting system. We consider that the most important issue that has resulted from these reforms refers to the introduction of consolidated financial reporting in the public sector. The public sector consolidated financial statements represent a challenging topic of worldwide research and also, became a debated issue both for international regulatory body (IPSASB) and for governments. However, the objective of this article is to analyze if there is a need for consolidated financial statements in the public sector and to outline the activity of the international regulatory bodies regarding the issuance of specific standards regarding this current topic. So as to reach this main objective of the research we explore the scientific literature regarding this issue and we followed the steps taken by regulators in the development of standards regarding consolidated financial statements that can be globally used. This theoretical paper emphasizes the importance of the introduction and presentation of consolidated financial statements by public sector entities and reveals the link between these types of reports prepared by entities from private sector and public one. The main conclusion of this conceptual paper is that public sector entities should prepare these consolidated reports and the regulators and governments play an important role in taking and introducing these practices into the public sector. So, we believe that there can be no excellence in accounting without excellence in reporting or vice versa.

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1. Introduction

Throughout recent years, the public sector was marked by a series of reforms that had a big influence on the accounting and reporting system. It was mainly due to an increasing internationalization of capital markets based on the background of a rapid development of economic globalization (Nistor, Stefanescu, 2012). The most important reform that took place in the public sector is the movement from cash-based accounting system to the accrual one. All these reforms could be seen as a revolution that occurred in the public sector organizations introduced by the NPM, fact also sustained by the researchers such as: Guthrie et al. (1998), Guthrie and Humphrey (1996), Pallot (1992), Jones et al. (2001), Grossi and Gardini (2012). The introduction of accrual accounting in public sector entities actually represents a first step towards the introduction of a new reporting system in the public sector, namely the consolidated reporting system. Although, this consolidated reporting system of public sector is not yet globally widespread, both governments and regulatory bodies in many countries make sustained efforts for the preparation and presentation of some consolidated reports at the public sector entities level. However, the opinions concerning the introduction of accrual accounting and the presentation of such reports in the public sector are both pros and cons. Some researchers believe that copying private sector practices and their application in the public sector is not exactly ideal, claiming that the objectives of the public sector, that differ from those of the private sector, should always be taken into account. Moreover, the direction towards which the accounting system in the public sector is going has been questioned, Chan (2003) asking himself if it is really necessary for governments to imitate without a critical sense the practices of the private sector. Also, Christiaens (2002) argues that the introduction of private sector methods and the lack of a conceptual framework for governmental accounting leads to the arising of a number of problems rather than solving them. However, although there are some retentions regarding the introduction of these practices, we believe that they are also necessary in the public sector because the whole public sector might be considered as a group of companies, and therefore a reporting system that gives us an overview of the public sector as a whole is needed.

Therefore, the purpose of this article is to investigate whether in the public sector the adoption and presentation of the consolidated financial statements (CFS) are more related to the information needs in the public sector. This research also focuses on the advantages and disadvantages of introducing and presenting the consolidated financial statements in public sector. Basing on this background, this paper will now develop as follows. After a brief overview of the literature on the public sector consolidated financial statements, section two highlights the main changes that determined the introduction and presentation of CFS in the public sector. Then, part three presents the activity of the international regulatory bodies regarding the issuance of specific standards regarding public sector consolidated financial statements, while section four summarizes the findings and presents the limits of the research, and the future prospect of research, too.

2. Literature review

The literature regarding the private sector consolidated financial statements is rather vast, which cannot be said about the literature regarding the public sector consolidated financial statements. Therefore, the public sector consolidated financial statements literature is sparse, and this lack of works about this topic is due to the novelty aspect of this issue in the public sector. So, if we compare the public and private sector consolidated reporting literature, it is undoubted that the main contributions to the concept of consolidation and to the development of this reporting system were brought by the private sector literature.

Although we believe that there are some differences between the two sectors, public and private, and between their goals, too, these practices that are applied in the private sector can be taken over by the public sector, as a financial reporting system.

Some relevant contributions to the development of the literature on the consolidated financial statements in the public sector were brought by some authors, namely: Grossi and Pepe (2008), Grossi (2008, 2009), Walker

(2009, 2011), Wise (2010), Christiaens, Rommel and Van Cauwenberge (2008), Bergmann and Bietenhader (2008), Tagesson (2008).

Grossi and Pepe (2008) try to underline the reasons which resulted in the appearance of consolidated reports in the public sector, the characteristics of consolidation, but also the similarities and differences between accounting principles and standards used for the preparation of consolidated financial statements in the public sector in 7 countries.

Walker (2009), believing in the benefits of implementing the consolidated financial statements in the public sector, from a theoretical perspective, highlighted the practices of consolidated financial statements in the public sector (especially in Australia), considering in this context, the general case of presenting consolidated financial statements covering the entire government and public administration. Walker (2011) also tried to identify the problems that occurred in the practice from Australia in the last two decades since 1988, and he suggested some ways to solve these problems by referring to the decisions that might be taken in routine circumstances by the users of these reports.

Wise (2010) examined the current literature related to the antecedents to public sector accountability performance by introducing a new variable, namely preparer-commanders' opinions about the usefulness of whole of government consolidated financial reporting and tried to find an answer to the question of whether the consolidated financial information is useful for government resource allocation decisions, not only for decision-making purposes.

Christiaens, Rommel and Van Cauwenberge (2008) examined the whole of government accounting framework as developed by IPSAS, trying to find answer to the following questions: What will be the consequences of applying IPSAS as a conceptual framework for Whole of Government Accounts? What type of accounting information will result from the application of IPSAS concept?

Grossi (2008, 2009) aimed at analyzing the impact and the possible effect on the consolidated financial reporting accounting and reporting system of Italian local government and he considers that CFR is a possible stimulus for the full implementation of accrual accounting and reporting. Through a complex study, Grossi identified the most common problems, obstacles to consolidated financial statements implementation at the local level, namely:

- lack of homogeneity of the accounting of local administrations and municipal companies;
- lack of expertise and know-how (insufficient knowledge about the consolidated reports);
- lack of staff;
- no obligation to completion;
- difficulties in obtaining necessary data and documents over time;
- limited transparency of annual reports of the local government; and
- lack of appropriate software.

Bergmann and Bietenhader (2008) studied, using a survey, the current situation in Switzerland regarding the consolidated financial reporting in public sector (the differences in practice and views on the consolidation introduction or not). Among the reasons for not presenting such cases they mentioned: the lack of interest or political pressure; the high costs of implementation; the lack of legal obligations; and technical problems.

Through a theoretical research involving a literature review and the expression of personal views Tagesson (2008) argues that consolidated reporting is needed in the public sector as a whole, but also for local administrations, and in the same time, he shows his support for proportionate consolidation in accordance with the method of acquisition.

All these studies represent a key factor in the development of the literature regarding this issue, arousing the interest for this topic to other researchers and practitioners.

3. Consolidated financial statements – a real need for public sector

The introduction and presentation of consolidated reports in the public sector are closely connected with the adoption of an accrual-based accounting system, idea also approved by some researchers (Guthrie, 1998). So, recognizing the importance of consolidated financial statements we will concentrate on the need of this reporting system for the public sector and on the changes that determined the introduction of such a reporting system. Lately, this issue is in the focus of many governments and regulatory bodies, and therefore many countries starting with the implementation of accrual based accounting system in the public sector began to prepare consolidated financial statements (Luder and Jones, 2003; Stalebrink and Sacco, 2006). The importance given to this subject is based on public sector need for a new financial reporting system which is able to provide a more comprehensive and accurate image over the entire public sector as a single entity. It is desired, and it also is also needed a reporting system that can provide more information to users at local, regional as well as central level. The development and growth of decentralized entities determined a series of debates about the need for consolidated financial reporting (Wise, 2006; Newberry, 2007) and it can be considered one of the main causes for introducing consolidated financial statements in the public sector. Given that public sector accounting lately suffered a series of significant changes, changes that led to the introduction of a new financial reporting system, namely the consolidated financial statements, we appreciate that these reforms represent some benefits that the public sector can take advantage. The changes that have had an important impact on the public sector refer to the New Public Management, the transition from an accrual to cash accounting, the imitation of private sector practices and the decentralization.

All these reforms that took place in the public sector do nothing but to arouse some controversies about the direction towards which goes the entire public accounting system. Thus, Barton (1999) doubts on the introduction of accrual accounting in the public sector, and this because of the significant differences between the two sectors, differences regarding each sector objectives, and resource allocation system. Also, Benito et al. (2007) underlined the necessity of not ignoring the peculiarities of the public sector, and the way the public accounting system has to adapt to the specific information needs of the sphere, while Chan (2003) tried to answer the question whether it is really necessary for governments to imitate without a critical sense the private sector practices. So, in the prior literature we can observe that researchers are quite apprehensive regarding the application of accrual accounting, and regarding the imitation of practices from the private sector. In fact, the transition from cash accounting to accrual accounting requires not only a change in the accounting system, but also a change in conception (OECD, 2002). All these changes that have revolutionized the public sector actually caused the introduction of consolidated reporting in the public sector, reports which can provide an overall image over the financial position and economic obligations of public institutions at local, regional and central level.

The financial statements can be considered as the main vehicle of information available for all users (Muniain, 2003). Whether discussing the public or private interest, the accountability is a requirement of New Public Management (NPM) postulates. The financial statements are considered a key accountability tool for different users (Nistor, Stefanescu, 2012), even if we talk about individual financial statements or consolidated financial ones.

The accrual accounting is considered to offer more useful information and to improve the government's transparency, accountability and performance evaluation. Although there are a lot of pros on the preparation and presentation of consolidated financial statements in the public sector, there are also opinions that consider that these consolidated reporting are not an example of best practices in government accounting. So, Milley (2002) noted that it is very difficult to see any value adds from the whole of government financial report, while Chow et al (2007) doubts about the value of a consolidation project in the public sector, highlighting the problems faced by the private sector entities regarding the consolidating accounting, the difficulties encountered in adapting consolidation accounting techniques for the public sector and the value of the accrual accounting in the public sector context. Furthermore, Montesinos and Brusca (2008) sustain that the

preparation of consolidated financial statements is a very difficult task which may need a long time, but it contributes to better understanding the government's financial position.

Consolidated financial reports are seen as one of the most significant accounting techniques of the public sector accounting reforms (Chan, 2003; Chow et al., 2007; Walker, 2009), and taking into consideration this aspect many governments consider that there are sufficient reasons for moving as quickly as possible to the preparation and presentation of such reports. The reasons which led to the development of these reports refer to the belief that public finances have become more transparent and financial statements of the whole public sector have provided a more real image on the financial position and performance. These consolidated reports can actually meet the needs of both internal and external accountability, but they also represent a feedback in the decision making process (Chow et al., 2007, Benito et al., 2007). The main role of consolidated financial statements is to meet the needs of a wider variety of users and to simplify the financial reporting system in the public sector.

At the same time, we can emphasize other arguments in favour of the preparation of consolidated financial statements in the public sector, such as: the ability of these reports to provide a more complex overview of the position, performance and state of the public sector as a whole, which cannot be provided by the individual financial statements of each entity forming the group and the ability of these reports to provide greater transparency and accountability regarding the public sector. As we mentioned above, we focused our attention on some of the advantages resulting from the preparation and presentation of consolidated reports. These advantages refer to the fact that the information provided to users is more transparent; we can make comparisons between countries; these reports are much easier to interpret and manage to create an overall picture of the economic condition of the entire public sector.

Simultaneously, the preparation of public sector consolidated financial statements causes a series of problems that should be over passed, namely: the lack of homogeneity of the financial statements prepared by controlled entities, the public sector standards must be different from those for the private one, the lack of professionals and the lack of the obligation for presenting consolidated reports.

4. IPSASB – an important actor in the development of public sector consolidated financial statements

The IPSASB is an independent standard-setting board which plays an important role regarding the regulation of public sector entities. The objective of IPSASB is to develop high-quality international public sector accounting standards for use by public sector entities around the world for preparation of general purpose financial statements. A number of 32 standards for public sector were issued by IPSASB, whose purpose is to improve the quality and transparency of public sector financial reporting. Therewith, IPSASB sustains that the adoption of IPSAS by governments will improve the transparency, quality and comparability of financial information reported by public sector entities around the world. The Committee and other important international organizations encourage both the adoption of IPSAS and the harmonization of national requirements with these international referentials. Although, the IPSAS are based on the International Accounting Standards, they are adopted to the needs of the public sector. IPSAS unlike IFRSs are not mandatory for public sector entities, but they were applied by many states. So, one thing is certain, namely international accounting standards become an international accounting culture (Whittington, 2008). Regarding the standards on the consolidated financial statements, IPSASB issued three standards, namely:

- IPSAS 6 Consolidated Financial Statements and Accounting for Controlled Entities, requires all controlling entities to prepare consolidated financial statements which consolidate all controlled entities on a line by line basis. A detailed explanation of the concept of control as it applies in the public sector and a brief guidance on determining whether control exists for financial reporting purposes are also included in this standard.
- IPSAS 7 Accounting for Investments in Associates, asks all investments in associate to be accounted for in the consolidated financial statements using the equity method of accounting, except when the investment is

acquired and held exclusively with a view to its disposal in the near future and thus, the cost method is required.

- IPSAS 8 Financial Reporting of Interests in Joint Ventures, requires proportionate consolidation to be adopted as the benchmark treatment for accounting for such joint ventures entered into by public sector entities. Also the equity method is allowed as an alternative treatment for accounting joint ventures.

Given that the main objective of the IPSASB is to maintain alignment with IFRSs for its standards that are based on an underlying IFRS, and that in May 2011, the IASB issued the following standards for which the IPSASB has equivalent standards: IFRS 10, Consolidated Financial Statements; IFRS 11, Joint Arrangements; IFRS 12, Disclosure of Interests in Other Entities; IAS 27 (revised 2011), Separate Financial Statements; and IAS 28 (revised 2011), Investments in Associates and Joint Ventures, it is time for revising IPSAS 6-8. Therefore, some projects have been initiated by IPSASB in order to examine the existing standards and the standards issued by IASB and to adapt them to the specificity of the public sector. One of the projects on the agenda refers to the revision of IPSAS 6-8, standards underlying the preparation and presentation of consolidated financial statements in public sector. So, in June 2011 a Project Brief named *Revision of IPSASs 6-8* was approved by IPSASB and this project has as main objectives to:

- Revise IPSAS 6 - Consolidated and Separate Financial Statements and relocate guidance relating to consolidated financial statements in a separate standard;
- Revise IPSAS 7 - Investments in Associates;
- Revise IPSAS 8 - Interests in Joint Ventures; and
- Locate all disclosures relating to interests in other entities in a separate standard.

However, professional regulatory bodies, and governments are the main organisms that contribute to the implementation and development of these consolidated reports in the public sector. This importance given to the preparation of consolidated financial statements can be seen from the importance given to projects on this the issue, and the experience of countries that have already introduced these reports.

5. Conclusions

Along with the reforms that have happened lately in the public sector the question that aroused is "Is there a need for consolidated financial statements in the public sector?". To find an answer to this question, we must first answer some other questions such as: Given that public and private sectors are based on different objectives, the private sector practices regarding the preparation and presentation of consolidated financial statements can be copied in the public sector?, Can these differences be overcome and is it possible for us to apply the same standards for both sectors?. These reforms are part of a wider global recognition of the necessity to improve financial management and the quality of financial information among public and private sector organizations. Given that the issue of consolidated financial statements in the public sector is a topic at the beginning of its development, it can be seen that the literature is not very extensive, rich. We can observe that professional regulatory bodies, and governments play a very important role in the implementation and development of these consolidated reporting in the public sector. The consolidated financial statements are useful instruments which are able to provide a clear and overall image of the whole public sector to both internal and external users. Although public sector consolidated financial statements are produced by a reduced number of countries, they began to play a special role in public sector accounting, and so the governments of many countries believe that there are many reasons to introduce and prepare whole of government financial statements as soon as possible. Due to the need of public sector for an increasing financial and political accountability, consolidated financial statements is the answer to fulfill this need.

The purpose of financial statements consists of the presentation of a true and fair view of an entity's financial performance, financial position, equity and cash flows and so, the consolidated reports represent a significant way to demonstrate how the public sector, both at individual entity and whole-of-government level, meets its financial management responsibilities. The presentation of financial statements that have the accrual

accounting at their basis is considered as providing more useful information to users of public sector than cash accounting. As mentioned above, IPSAS are based on private sector standards, standards that are based on the decision-making approach, but they are also adapted to the specificity of the public sector. It can be seen a growing interest from both practitioners and researchers for the adoption of a single set of standards for all the public sector entities and for the implementation of a new financial reporting system in the public sector. All these above mentioned facilitate the comparability between countries and provide a more transparent picture regarding the status and the direction undertaken by the governments of different countries.

The reform determined important changes in the accounting and financial reporting system, changes that refer to the introduction of accrual-based accounting, moving from cash-based accounting and the presentation of consolidated financial statements. Walker (2009) states that the preparation of a unique set of consolidated statements comprising the whole of government is supported worldwide, idea that we totally agree. Although there are some difficulties in developing public sector consolidated financial statements, we conclude that these reports improve and bring value to the public sector reporting system regarding the financial performance and thus allow increased the accountability on public resources. Certainly, the experience of countries that have already implemented these practices will be copied by other states, which make sustained efforts in order to introduce these is in a short time.

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